

STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 7712

Request of Vermont Gas Systems, Inc. to establish a)
System Expansion and Reliability Fund with funds)
provided by reductions in the quarterly Purchase Gas)
Adjustment rate under the Alternative Regulation Plan)

Order entered: 9/28/2011

ORDER AMENDING ALTERNATIVE REGULATION PLAN

I. INTRODUCTION

Vermont Gas Systems, Inc. ("VGS" or the "Company"), supported by the Vermont Department of Public Service (the "Department"), has proposed the establishment of the System Expansion and Reliability Fund (the "Expansion Fund") for VGS for the purpose of facilitating further build-out of its system. Under the Company's proposal, the Expansion Fund would be used to help VGS expand its natural-gas system into the Vergennes and Middlebury market areas by smoothing the rate trajectory that would otherwise be expected if the expansion project were constructed. VGS proposes to deposit approximately \$4.4 million annually into the Expansion Fund, initially by using money that would otherwise go immediately to reduce rates for existing customers pursuant to provisions of the Company's Alternative-Regulation Plan (the "ARP") and subsequently through incorporating into rates the money that would be deposited into the Expansion Fund. Under VGS's proposal, if such an expansion did not occur, the Board could decide that money in the Expansion Fund should be returned to ratepayers.

In this Order, the Vermont Public Service Board ("Board") approves, subject to conditions set out herein, the proposed Expansion Fund.¹ In particular, we approve an amendment to VGS's ARP, in accordance with the terms of a Memorandum of Understanding between VGS and the Department, filed with the Board on May 16, 2011 (the "MOU"), authorizing VGS to establish the Expansion Fund, in lieu of decreasing customer rates.

1. Board Member John Burke does not join in this ruling and has written a separate, dissenting opinion.

The expansion of natural gas service has long been a goal of Vermont energy policy. Expanded natural gas availability could provide significant benefits to Vermont residential and business consumers in newly served areas through introduction of a lower-cost fuel source into those areas. It also has the potential to reduce greenhouse gas emissions, by displacing fuels with higher carbon content.

The proposed Expansion Fund, supplemented by the provisions of the MOU, provides a creative mechanism that may help facilitate such expansion. Effectively, VGS will collect money now from ratepayers that would be used to offset potential future rate increases that may arise from the potential system expansion. VGS expects that this mechanism will enhance the economic viability of the extension of service to Vergennes and Middlebury. The Expansion Fund mechanism may also represent one of the best means to achieve the state's goal of expanded natural gas service. This Board has tried to encourage such expansion in the past, through higher rates of return and approval of the ARP, although these efforts have not heretofore borne fruit. Given this lack of success, the Expansion Fund mechanism may represent the best opportunity for extending natural gas service to Addison County in any reasonable time frame. We recognize some concerns with having ratepayers pay higher rates now for potential benefits later, but on balance, we conclude that the potential benefits to consumers in Vermont outweigh these and other concerns. These benefits include a potential reduction in greenhouse gases in Vermont, which will help all Vermonters, including existing VGS customers and an incentive for increased economic development. Moreover, the MOU and Expansion Fund seek to secure these consumer benefits while still maintaining reasonable overall rate levels — natural gas costs now are substantially lower than they have been.

The establishment of the Expansion Fund is also consistent with the goals of authorizing VGS to operate under the ARP five years ago.² Although it is possible that we could have approved the MOU and the Expansion Fund under traditional regulation, the ARP provided incentives for VGS to develop a different approach to increase the likelihood that VGS can develop a plan that will promote the general good of the state and extend natural gas service.

2. *See in re Vermont Gas Systems*, Docket No. 7109, Order of 9/21/06 (for example, the Board included conditions requiring VGS to regularly examine the effect of the ARP on system expansion).

Vermont law governing alternative regulation for natural gas and electric companies also explicitly authorizes the Board to vary traditional regulation where we find, as here, that such variations promote the general good of the state.

However, our decision to authorize the Expansion Fund is limited. We are not deciding today how or even whether the Expansion Fund might be used: such decisions will be made at a later date. At the present time, VGS has not filed with this Board a concrete proposal for system expansion, although it has targeted Vergennes and Middlebury as likely centers of new distribution systems. As a result, we have no basis to conclude now that any such proposal would be cost-effective or in the best interests of VGS, its ratepayers, and the public good. Any expansion of the Company's transmission system to bring natural-gas service to Addison County would also require review and approval under the rigorous criteria established by 30 V.S.A. § 248. Determinations on these issues await further filings from VGS.

Today, we conclude only that the establishment of the Expansion Fund may produce benefits to Vermont that might not be attained in the absence of such a fund. The Expansion Fund is also subject to various safeguards and oversight. VGS may not make distributions from the Expansion Fund until such time as the Board affirmatively authorizes them. VGS is required to report quarterly to the Board and the Department on the Expansion Fund and its expansion plans. Moreover, money contributed by ratepayers will earn interest at a rate that reflects the customers' time-value of money. VGS has also committed to track all customers' payments into the Expansion Fund. This means that if expansion of the system does not occur, the contents of the Expansion Fund can be returned to the specific customers that paid into the Fund.³ With these safeguards, VGS ratepayers should be fully protected, either by being able to obtain a future refund or through the assurance that the Board has reviewed expenditures from the Expansion Fund and has been persuaded that such expenditures are in the best interest of the state.

3. Tracking customers will obviously be more challenging over time. However, we disagree with the dissent's suggestion that such tracking may not be possible; it is our understanding that companies that have such an obligation, can plan for it and successfully track customers. But, we recognize that if the timing for VGS to pursue system expansion is delayed from the current projections, it may be appropriate to reexamine VGS's ability to still provide refunds to customers that have relocated.

II. BACKGROUND AND PROCEDURAL HISTORY

On February 7, 2011, VGS filed a letter requesting that the Board issue an accounting order authorizing VGS to establish the Expansion Fund by deferring and escrowing savings that would otherwise be passed through to ratepayers from an anticipated rate reduction resulting from the Company's quarterly Purchase Gas Adjustment ("PGA") under the ARP. VGS requested expedited review and approval by the Board of the proposed order in light of the Company's obligation under the ARP to begin notifying customers of the quarterly adjustment on February 22, 2011. VGS also stated that it was discussing with the Department the possibility of developing a Memorandum of Understanding regarding the recovery of development costs for the proposed expansion.

On February 14, 2011, the Department filed a letter indicating that it had entered into a Memorandum of Understanding with VGS supporting issuance of an accounting order establishing the Expansion Fund. The Department noted that under this agreement our approval of the requested accounting order would only establish the Expansion Fund but would not address cost recovery or specific projects.

In an Order dated February 16, 2011, the Board concluded that since VGS's proposal would have direct effects upon the rates charged to customers, it was more appropriate to consider VGS's proposal as a request to modify the ARP rather than simply a request for an accounting order. The Board also opened this docket to consider the merits of VGS's request and authorized VGS to establish the Expansion Fund on an interim basis, pending resolution of proceedings in this docket.

On March 9, 2011, we convened a prehearing conference, at which the Board decided to conduct a workshop and outlined a list of questions and issues for VGS to address. The Board also provided this list of questions to VGS in a memorandum dated March 16, 2011. By letter dated March 21, 2011, VGS submitted a preliminary response to the Board's questions.⁴

On March 22, 2011, the Board conducted the workshop. At the close of the workshop, the Board discussed with the parties the possibility that the transcript of the workshop, supported

4. See ltr. of Eileen Simollardes (March 21, 2011).

by affidavits filed by workshop participants, as well as VGS's presentation slides and supporting materials would be treated as part of the record in this docket.⁵

On May 11, 2011, the Board conducted a public hearing in South Burlington, Vermont. Thirteen members of the public spoke at the public hearing. The majority of commenters supported the establishment of the Expansion Fund and expansion of service to Addison County.⁶

On May 16, 2011, VGS and the Department filed the MOU, outlining a series of agreements between the parties. The parties also agreed that the transcript of the March 22 workshop, and VGS's responses to the Board's questions filed March 21 and March 24 would be made part of the record.⁷

On May 17, 2011, VGS filed a Proposal for Decision ("PFD"). VGS represented that the Department had authorized it to state the Department's support for the PFD if the Board's decision was consistent with the PFD in all material respects.

On June 14, 2011, the Board held a technical hearing to consider VGS's proposal and the MOU.

On July 1, 2011, VGS filed its Brief.

On July 7, 2011, the Department filed a letter stating its support for a portion of VGS's Brief and responding to the other portion.

5. See tr. 3/22/11 at 113–114 (Volz). The parties subsequently agreed to such admission in the MOU.

6. Tr. 5/11/11 at 8–41.

7. MOU at 5.

III. FINDINGS

Based on the evidence submitted in this case,⁸ the Board finds as follows:

A. Background: VGS's Plans for Expansion

1. VGS currently provides natural gas service to approximately 45,000 customers in Chittenden and Franklin Counties. Tr. 3/22/11 at 6–10 (Gilbert).

2. VGS is evaluating the possibility of extending its system to the Vergennes and Middlebury market areas (the "Expansion Project"), with the long-term goal of further expansion to Rutland and interconnection with the U.S. pipeline system. This expansion would occur in stages to mitigate rate impacts and to avoid harming VGS's competitive position in the market. See tr. 3/22/11 at 22, 53–55 (Gilbert), 72 (Simollardes); MOU at 1.

3. The expansion would also involve increasing the capacity of the existing transmission system, bringing transmission around Burlington and bringing distribution or possibly transmission to Addison County to serve Vergennes and Middlebury. VGS expects that existing customers in Chittenden and Franklin Counties would benefit from the added reliability and capacity that would result from these upgrades. Tr. 3/22/11 at 15–16 (Gilbert), 44–46 (Lyons).

4. At this time, VGS estimates that the expansion of VGS's existing system to Vergennes and Middlebury could result in up to \$44 million in net benefits to Vermont over 20 years and could reduce overall energy costs to homes and businesses in the state. It could result in statewide benefits including the expansion of the state's energy supply from a North American-sourced fuel and a reduction in Vermont's energy costs and could contribute to economic development. Tr. 3/22/11 at 14–15 (Gilbert).

5. VGS estimates that the cost of expanding to Vergennes and Middlebury would be between \$60 and \$70 million. VGS anticipates raising this capital by issuing debt and investing equity capital. Tr. 3/22/11 at 17 (Gilbert); see letter of Simollardes (March 21, 2011), attachment at 2; tr. 6/14/11 at 8 (Gilbert).

8. The evidentiary record consists of (1) the transcript of the Board workshop held on March 22, 2011, (2) the Company's written response to the Board's memorandum dated March 16, 2011, (3) the presentation slides VGS submitted in connection with the workshop, (4) additional maps and materials provided to the Board on March 24, 2011, (5) the MOU submitted to the Board on May 16, 2011, and (6) the transcript of the June 14 technical hearing.

6. VGS does not expect that the new Vergennes and Middlebury markets, consisting of approximately 3,000 customers, will be large enough to pay for the Expansion Project by themselves. Tr. 3/22/11 at 18–19 (Gilbert), 109–110 (Simollardes, Gilbert); tr. 6/14/11 at 83–84 (Simollardes).

7. VGS expects that the introduction of natural gas to Addison County will help reduce greenhouse gas emissions. VGS estimates that its previous expansion into Jericho saved over 900 tons of CO² annually. Tr. 3/22/11 at 9–10, 13–15 (Gilbert).

B. Establishment and Maintenance of the System Expansion and Reliability Fund

8. Under VGS's ARP, the PGA rate mechanism provides for a quarterly adjustment of firm customers' rates based on changes in "Gas Costs" as defined under the ARP. Any cost reduction or increase is passed on to these customers. *See* Order Re: Modification of Alternative Regulation Plan and Notice of Prehearing Conference, dated 2/16/11, at 2.

9. Under the ARP, VGS would have been required to reduce customer rates effective April 22, 2011, to reflect the decline in gas costs that had occurred. This rate reduction would have amounted to approximately \$4.4 million annually or 5.4 %. Tr. 6/14/11 at 12 (Gilbert).

10. As of the time of VGS's original request, VGS had filed nine rate reductions in the previous ten quarters. VGS Request for Accounting Order at 2.

11. Under VGS's proposal, instead of receiving a rate reduction as a result of the April 2011 PGA, the customers' rates remained unchanged. The MOU provides that the money that would have been refunded through the PGA adjustment will instead be deposited in the Expansion Fund. MOU at 3.

12. The MOU obligates VGS to deposit revenue equal to the difference between the rates in effect on April 2011 and those that would have taken effect on that date if the PGA under its ARP had been implemented. These deposits will be placed monthly into an interest-bearing account that will be escrowed separately from other Company accounts. VGS proposes that this account will accrue interest at the customer deposit rate. MOU at 1, 4; tr. 6/14/11 at 115 (Simollardes).

13. VGS estimates that approximately \$4.4 million will be deposited into the Expansion Fund annually under its proposal. Tr. 3/22/11 at 91 (Simollardes); ltr. of Simollardes (March 21, 2011), attachment at 2.

14. VGS is proposing a one-time deviation from the ARP's PGA mechanism; it is not proposing to deposit revenues from any future reductions in the wholesale price of gas into the Expansion Fund. Tr. 3/22/11 at 70, 91 (Simollardes).

15. Effective with approval of the proposed Expansion Fund, the difference in rates will be reflected in the distribution charge of VGS's firm rates rather than in the natural gas charge. Moving collection of the Expansion Fund from the natural gas charge to the distribution charge will not affect the amount collected and the impact on customers is unchanged. MOU at 3–4; ltr. of Simollardes (March 21, 2011) at 5.

16. The MOU further obligates Vermont Gas to detail the Expansion Fund's monetary value in the quarterly reports that VGS must file with the Department and Board under the ARP. MOU at 4–5.

17. The purpose of establishing the Expansion Fund is to facilitate the proposed Expansion Project as well as VGS's ability to expand service to other unserved areas while mitigating future rate increases. The contents of the Expansion Fund would be available to reduce rate impacts in the future unless the Board decides that the monies should be returned to customers. MOU at 1, 3; ltr. of Simollardes (March 21, 2011) at 4; tr. 6/14/11 at 7 (Gilbert).

18. VGS does not propose that the assets in the Expansion Fund would represent a customer investment in VGS facilities. Customers would instead pay rates to cover the cost of the service they receive (including depreciation, debt service and a reasonable return on shareholder investment), which includes the cost of the Company's transmission and distribution system including the Expansion Project if and when it is approved and commissioned. Tr. 3/22/11 at 60–61 (Simollardes); *see also* ltr. of Simollardes (March 21, 2011) at 1.

19. Without the Expansion Fund, VGS anticipates a rate "swing" that could be as large as 15%, between March 2011 and when the Expansion Project would go into service. In particular, without the Expansion Fund rates would decrease by 5% under VGS's existing ARP, but as a result of commissioning the Expansion Project rates would likely subsequently increase by 10%.

Thus, one of the purposes of the Expansion Fund is to promote rate stabilization. *See* tr. 3/22/11 at 63–66 (Simollardes).

20. The Expansion Fund would be treated as a regulatory liability. Monies in the fund would ultimately be returned to customers and would not be withdrawn by VGS unless authorized by the Board. The Expansion Fund would be escrowed in a separate, interest-bearing account with interest retained in the Fund. Tr. 3/22/11 at 64, 96 (Simollardes); *see* MOU at 4; ltr. of Simollardes (March 21, 2011) at 1.

21. VGS can track customers that have contributed to the Expansion Fund, so that if the Fund is terminated, refunds will go to the customers that contributed. Tr. 6/14/11 at 37 (Gilbert).

22. The MOU provides that the Expansion Fund will continue until 2031 unless terminated earlier by the Board. MOU at 6.

23. VGS does not anticipate requesting the Board to approve use of the assets in the Expansion Fund until VGS has completed construction of the expansion. Tr. 6/14/11 at 87 (Simollardes).

C. Amendment of the Alternative Regulation Plan

24. In the MOU, VGS and the Department agree to certain amendments to Paragraph 10 of VGS's existing ARP. In particular, the MOU provides that the ARP will be amended to authorize VGS to establish the Expansion Fund. MOU at 2–3.

25. Under the amended ARP, VGS will report to the Department on the status of the Expansion Fund and the Expansion Project annually, and the MOU further requires the Department and VGS to meet to assess the Expansion Fund's effectiveness in supporting system expansion twice during the next ten years and every three years thereafter. MOU at 2, 6.

26. The MOU states a generalized goal that the contents of the Expansion Fund will be available either to reduce the rate impact of VGS's proposed expansion to Addison County or returned to VGS customers if the Expansion Project is not implemented, as the Board will determine. But the MOU also provides that it does not address the specific uses of money in the Expansion Fund. MOU at 3, 6.

27. The MOU also provides that the ARP will be amended to indicate that VGS will have no authority to use Expansion Fund monies without an order of the Board approving such use. MOU at 3.

28. Finally, the MOU provides that the ARP will be amended to state that the Expansion Fund will remain in place regardless of whether VGS's rates are established pursuant to an ARP or traditional rate regulation. MOU at 3.

29. Amending the ARP to establish and implement the Expansion Fund does not affect our previous findings in Docket Nos. 7109 and 7537 in which we approved VGS's ARP. *See* ltr. from Eileen Simollardes dated Dec. 30, 2010.

D. Development Costs

30. Under the MOU, the Department and VGS agree that prudently incurred development costs related to the system expansion project are recoverable from customers. The MOU further provides that, if the project is constructed, the development costs would be included as part of project costs and recovered over the life of the project; if the project is not constructed, such development costs would be recovered from the Expansion Fund "as authorized and in a manner prescribed by the Board." MOU at 4–5; tr. 6/14/11 at 47–48 (Gilbert).

31. VGS agrees to detail development costs that it incurs as part of the quarterly reports filed under the ARP. MOU at 5; tr. 6/14/11 at 114–115 (Simollardes).

IV. DISCUSSION

VGS now provides natural gas service to northwestern Vermont; its present system extends from the Canadian border to the towns of Shelburne, Jericho, and Hinesburg. VGS is presently contemplating the possibility of extending the system to Vergennes and Middlebury, with a long-term goal of further expansion southwards.⁹ VGS maintains that the expansion of the system could provide benefits to Vermont, including adding a North American-sourced and economical fuel to new markets, reducing Vermonters' energy costs, and contributing to

9. MOU at 1.

economic development. To facilitate such expansion, VGS proposes that the Board allow it to establish the Expansion Fund.

A. The Expansion Fund

The proposed Expansion Fund would be created through a modification to the Company's ARP and an adjustment to the Company's rates going forward. Under the ARP, VGS makes quarterly adjustments to its rates based upon changes in the cost of natural gas supply. VGS proposed to use the reduction that would otherwise have been effective in April to create the Expansion Fund, so that instead of lowering rates by approximately 5%, VGS maintained rates unchanged.¹⁰ In the MOU, VGS and the Department propose to amend the ARP to make this rate adjustment permanent, by adding a line item to the cost of distribution services.¹¹ VGS estimates that these changes will generate approximately \$4.4 million annually, which would be deposited in the Expansion Fund.

The purpose of the Expansion Fund, as described by VGS and in the MOU, is to facilitate expansion of its system to Addison County. It would achieve this by reducing the rate impact of the Project.¹² VGS projects that it would use the assets collected in the Expansion Fund to "smooth rates" going forward, so that there may be less upward pressure on rates if the expansion takes place. This, in turn, VGS asserts, will provide it an advantage in securing customers in the new areas.¹³ VGS does not plan to use the funds as part of its capital investment.

The current proposal does not, however, contain specific measures on the uses of the Fund. Instead, the MOU specifically states that it "does not in any way address the use of Fund monies."¹⁴ Any use of the Expansion Fund would have to be specifically authorized by the Board in future proceedings. The MOU provides that the Board may determine in the future whether to authorize VGS to use the Expansion Fund or whether it should be returned to

10. The Board approved this on an interim basis. Order of 2/16/11.

11. MOU at 3–4.

12. MOU at 1.

13. Tr. 6/14/11 at 26–30 (Gilbert). VGS now has approximately a 30% competitive advantage over alternative fuels. *Id.* at 33–34 (Gilbert).

14. MOU at 6.

ratepayers.¹⁵ The parties have also agreed that the Expansion Fund will remain in effect (and as a line item in rates) until 2031, unless terminated earlier by the Board. VGS will provide periodic reports to the Board and Department on the Expansion Fund.¹⁶ Finally, any dispute concerning the Fund will be resolved by the Board.¹⁷

We find VGS's proposal to be reasonable and approve it. Creation of the Expansion Fund increases the potential for VGS to be able to extend its system significantly; under the first stage of expansion that VGS is contemplating, the line would be extended to Middlebury, greatly increasing the reach of the system. Such expansion could greatly benefit businesses and residential consumers that currently have no natural gas service available to them, by introducing a new lower-cost, and lower-carbon, fuel source.

There is a cost associated with establishing the Expansion Fund — VGS consumers will pay approximately 5% more in rates annually. If system expansion ultimately does not occur, this money would be returned to them, with interest reflecting the time-value of the money. If the expansion occurs, it will be because the Board determines that VGS has demonstrated that such expansion will promote the general good of the state, even after consideration of the costs of the money in the Expansion Fund.

At this time, however, the Board takes no position on whether VGS should be authorized to expand its system. That issue, and other uses of the Expansion Fund, are not before us. At such time as VGS seeks approval of its system expansion plans, or seeks permission to use portions of the Expansion Fund, the Board will thoroughly review those issues.

We understand the dissent's concern about the establishment of the Expansion Fund and the potential for subsidization of future customers by existing ones. With the conditions we have put in place, and VGS's commitment to track customers who may leave the system, we find the concerns about the Fund itself to be misplaced. If we conclude that expansion should not occur, customers will be refunded their payments. As to the question of cross-subsidization, it is

15. MOU at 6.

16. Tr. 6/14/11 at 113–114 (Simollardes).

17. Tr. 6/14/11 at 137 (Hofmann).

premature. We would expect to carefully consider whether unjust cross-subsidization occurs as part of any review of the Project once filed.

We also disagree with the dissent's contention that the Expansion Fund represents a form of venture capital that should come from VGS's parent, not its ratepayers. As we explained above, at the present time, VGS is proposing that the Expansion Fund would be used to reduce the amount by which rates may need to increase in the future if the project is constructed and the investment added to rate base. This is a mechanism designed to "smooth" rates, which has the same purpose as our past phase-in of rate adjustments. VGS testified that the actual capital for the investment would not be provided by ratepayers, but rather from the Company, using retained earnings, borrowing, and, if necessary, a capital infusion from the parent company.¹⁸ But the dissent also misses a fundamental point: over time, ratepayers will pay all the prudently incurred costs associated with the construction project, whether financed by VGS or Gaz Metro. This is true for any capital construction utility project approved by this Board in Vermont. The Expansion Fund does nothing to alter that reality: it simply would change the timing of those payments in a manner which would make the potential for expansion more likely and feasible, thereby creating the potential for broader benefits.

B. Review of the Expansion Project

The proposed expansion of VGS's system to Middlebury and Vergennes is a sizeable project. It is expected to entail enhancement of the transmission system in the area around Burlington. In addition, VGS plans to extend the existing natural gas system from its present southern terminus in Shelburne to Vergennes and then to Middlebury, which will substantially extend the reach of VGS's system.

VGS has made generalized references to which aspects of the system expansion would be submitted for Board review and approval. During the evidentiary hearing, VGS appeared to view the scope of Board review under 30 V.S.A. § 248 as limited, stating that it expected to seek

18. Mr. Gilbert testified: "The company would make the investment. It would be a combination of retained earnings that the company would have to apply towards that, plus borrowing, and to the extent that we needed further capital, we could turn to our parent company and ask for an equity infusion. But it would be investment by the company." Tr. 6/14/11 at 8 (Gilbert).

approval under Section 248 of only those portions of the project that it regards as transmission upgrades.¹⁹ In its brief, VGS contended that Section 248 only required prior review and approval for transmission lines.²⁰ More broadly, VGS asserted that the planned expansion of the distribution system was not "incident to" the transmission lines, thus requiring approval under Section 248. Nonetheless, VGS argued that the Board need not resolve whether the proposed expansion would be subject to Section 248, since the Company would commit to provide the Board with information allowing it to review the proposed expansion; VGS stated that it would "submit [the distribution facilities] for review by the Board as part of any Section 248 petition filed for the Project."²¹ VGS also observes that the Board can investigate "Project distribution facilities" under Section 209.

The Department argues that VGS's analysis of Section 248 'may be both premature and possibly too narrow as it relates to the Project.' The Department maintains that, at this time, only the question of whether to create the Expansion Fund is before the Board, not broader questions of the scope of future review that may be better informed by further information. The Department also contends that the Board has ample authority under Section 209, notwithstanding any limitations on Board jurisdiction pursuant to Section 248.

The Department is correct that VGS has not yet filed a concrete expansion plan so we cannot definitively determine whether the proposed system expansion (and what portions of that expansion) require prior Board approval under Section 248. Nonetheless, as a condition of our approval of the modification to the ARP and establishment of the Expansion Fund, we find that, at a minimum, VGS must obtain prior approval for the transmission upgrades in the Burlington area as well as the expansion of the system to Vergennes and Middlebury.

Moreover, VGS is asking for a substantial exception to normal ratemaking principles through its request to establish the Expansion Fund. In this sense, there are parallels to the approach the Board adopted to small, renewable power generation under Rule 4.100. In that context, the Board determined that if a company wanted special rate treatment (*i.e.*, long-term

19. Tr. 6/14/11 at 51 (Gilbert).

20. VGS Brief at 3–5.

21. VGS Brief at 10–11.

levelized rates), the project would need to be reviewed under the criteria of Section 248, even if it would normally be exempt from such review.²² We find the same approach to be reasonable here. Because of the special rate treatment accorded VGS and the substantial amount of ratepayer funds being provided in advance of a specific project, we will require VGS to seek approval for the expansion under Section 248. We note that this requirement is consistent with VGS's commitment to make all of its expansion available for review as part of its Section 248 petition.²³

VGS also may benefit from understanding the potential scope of review now. It would be disadvantageous for VGS and, potentially, the state if the Company took a narrow view of the scope of approval and the Board then concluded that a larger portion of the Project must be considered to be transmission under Vermont law and thus required prior Board approval. In this instance, VGS would then need to develop all of the evidence to demonstrate that the Project met the Section 248 criteria for additional segments of the expansion. This would inevitably produce added costs and delays, which could adversely affect customers.

C. Development Costs

In the MOU, the Department and VGS agree that "prudently-incurred development costs related to the Project are recoverable from customers."²⁴ Development costs include a range of expenses related to the Project's permitting and pre-permitting work. Under the MOU, if the Project is constructed, the costs would be recovered over the term of the investment; if the Project is not constructed, these costs would be recoverable "as authorized and in a manner prescribed by the Board."

At the hearing, the Board questioned whether development costs are recoverable from ratepayers if a construction project is not completed, even if they were prudent. In its Brief, VGS argues that such costs should be recoverable for two reasons. According to VGS, partial recovery of development costs is consistent with Board precedent. VGS asserts that the used-

22. Board Rule 4.104(H).

23. VGS Brief at 11–12.

24. MOU at 4.

and-useful doctrine has not been viewed as a total bar to the recovery of costs, but rather allows some sharing of those costs.²⁵ VGS observes that the Board has previously recognized the value of research and development costs and allowed recovery of those costs in conjunction with an in-state renewable resource. VGS contends that it is expected to conduct research and develop projects, some of which may not come to fruition; the risks of these activities, VGS asserts, should not rest solely on the Company.

VGS also argues that the Board need not determine whether the used-and-useful doctrine applies since under alternative regulation, the Board may alter normal ratemaking practices. Here, VGS maintains that the MOU is intended to provide the type of incentive contemplated by alternative regulation by allowing recovery of prudently incurred development costs.²⁶

The Department supports VGS's analysis.

This Board has previously concluded that the statutory standard of "just and reasonable" affords us broad discretion in the manner in which we determine rates, which would include the costs that a utility may include in its rates.²⁷ The Vermont Supreme Court has stated:

The statutory basis of the Board's regulatory authority is extremely broad and unconfining with respect to means and methods available to that body to achieve the stated goal of adequate service at just and reasonable rates. 30 V.S.A. § 218 authorizes the Board to set rates, tolls, charges or schedules or to change regulations, measurements, practices or acts of the utility relating to its service in order to insure those reasonable rates and adequate service. The choices the Board makes in this area are subject to great deference in this Court so long as it can be shown they are directed at proper regulatory objectives.²⁸

This standard does not provide unfettered discretion to vary traditional ratemaking practices, but it does permit the Board to vary such practices where it is demonstrated that such actions will promote the general good and ensure just and reasonable rates.²⁹

25. Citing *Tariff Filing of Central Vermont Public Service Corp.*, Docket No. 5132, Order of 5/15/87, and *Tariff Filing of Green Mountain Power*, Docket No. 5983, Order of 2/27/98.

26. VGS Brief at 15–16.

27. See, e.g., Docket 5983, Order of 6/8/98 at 2, 22–23, 25.

28. *In re Green Mountain Power Corp.*, 142 Vt. 373, 380 (1983) (citations omitted); accord, *In re Citizens Utilities Co.*, No. 97-436, slip op. at 7 (Vt. Dec. 15, 2000).

29. See *Petition of Green Mountain Power*, Docket No. 6107, Order of 1/23/01.

The Board has substantial flexibility to alter general ratemaking principles as part of an alternative regulation plan. Section 218d of Title 30, which permits the use of alternative regulation, authorizes the Board to use "such changes or additions to, waivers of, or alternatives to, traditional rate-making procedures . . . as the board finds will promote the public good" and will support the required statutory findings.³⁰ One of the statutory findings, set out in subsection 218d(a)(4), is to "offer incentives for innovations and improved performance that advance state energy policy."

The MOU would authorize VGS to recover all prudently incurred development costs, even if the expansion project for which those funds are collected is not constructed. Considering the potential benefits to the state of system expansion, we find this provision to be acceptable. The assurance of cost recovery should provide VGS with the incentives it needs to develop and implement system expansion, which is consistent with the ARP and the statute authorizing it.

D. Interest on the Expansion Fund

Under the MOU, VGS will establish a separate account for the Expansion Fund. The MOU provides that VGS will accrue interest on the amounts in the Fund. In testimony, VGS originally proposed that interest would be accrued at the current rate that applies to customer deposits.³¹ VGS subsequently stated that the rate would be the prevailing market rate for the account VGS established.³² VGS asserts that this amount is appropriate, rather than a market-based or customer-based discount rate because the Expansion Fund "is ultimately really for the benefit of the customer."³³

The Board accepts the MOU's provisions for interest with one condition. The interest rate on the amounts in the Expansion Fund should be the higher of the market rate or the customer-deposit rate originally proposed by VGS. This will ensure that customers are compensated for the lost time-value of money at least at the same rate that the Board now applies to all customer deposits.

30. 30 V.S.A. § 218d(d).

31. Tr. 3/22/11 at 91 (Simollardes).

32. Tr. 6/14/11 at 116 (Simollardes).

33. Tr. 6/14/11 at 117 (Simollardes).

V. CONCLUSION

The Board finds that the establishment of the Expansion Fund as described in our findings of fact above, to be managed as set forth in the MOU and as explained in this Order, will promote the general good and should be approved. The proposed amendment to the ARP, which provides for the creation and management of the Expansion Fund, is also approved. In issuing this Order, the Board is not approving any expenditures of the monies from the Expansion Fund at this time nor approving any particular expansion or reliability projects.

VI. ORDER

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED by the Public Service Board of the State of Vermont that:

1. The Memorandum of Understanding between Vermont Gas Systems, Inc. ("VGS"), and the Vermont Department of Public Service, filed with the Public Service Board ("Board") on May 16, 2011, is hereby approved, subject to the conditions set out in this Order.
2. The proposed amendments to Paragraph 10 of the Alternative Regulation Plan ("ARP"), contained in Section 1 of the MOU, are consistent with the Plan previously approved under 30 V.S.A. § 218d and are hereby approved.
3. Within 21 days of this Order, VGS shall file a revised version of its ARP incorporating the amendment to Paragraph 10 approved in this Order.
4. The System Expansion and Reliability Fund shall accrue interest at the higher of the prevailing rate paid by the account established by VGS or the customer deposit rate established by the Board.
5. If VGS intends to seek approval from the Board to use the Expansion Fund in conjunction with a particular system expansion project, VGS shall file the entire expansion project for Board review pursuant to the criteria of 30 V.S.A. § 248.
6. VGS shall track each individual customer that makes payments that are deposited into the Expansion Fund and the amount of each customers' contributions.

Dated at Montpelier, Vermont, this 28th day of September, 2011.

<u>s/James Volz</u>)	
)	PUBLIC SERVICE
)	
<u>s/David C. Coen</u>)	BOARD
)	
)	OF VERMONT
)	

OFFICE OF THE CLERK

FILED: September 28, 2011

ATTEST: s/Susan M. Hudson
Clerk of the Board

NOTICE TO READERS: This decision is subject to revision of technical errors. Readers are requested to notify the Clerk of the Board (by e-mail, telephone, or in writing) of any apparent errors, in order that any necessary corrections may be made. (E-mail address: psb.clerk@state.vt.us)

Appeal of this decision to the Supreme Court of Vermont must be filed with the Clerk of the Board within thirty days. Appeal will not stay the effect of this Order, absent further Order by this Board or appropriate action by the Supreme Court of Vermont. Motions for reconsideration or stay, if any, must be filed with the Clerk of the Board within ten days of the date of this decision and order.

DISSENTING OPINION OF JOHN D. BURKE

I cannot agree with my colleagues' approval of the requested modification of Vermont Gas System, Inc.'s ("VGS") Alternative Regulation Plan and must therefore dissent. I do share their desire to have the VGS footprint expand in Vermont and that is why I was willing to join my colleagues in granting VGS a higher rate of return. As we stated in our Order in Dockets 6946 and 6988:

With regard to VGS, the Board authorized a 10.98 percent return on equity as an incentive to investors to assume a greater risk for building out VGS's transmission pipe system into areas of Vermont that are currently unserved.

I am not, however, willing to agree that the present ratepayers should provide even more financial support for the exploration of the feasibility of system expansion, which the Expansion Fund and the MOU will do.

It is obvious that several rate decreases have benefited the customers of VGS in recent years. It should, however, be noted that these decreases were driven by the lower cost VGS had to pay for its gas supply and thus there was no detriment to VGS. In fact, it was VGS who petitioned the Public Service Board for an Alternative Regulation Plan, which is what led to the rate decreases. The primary argument in that docket was the theory that the reduction of regulatory lag benefitted everyone. Gas cost increases and decreases would be passed to ratepayers quicker, would require less regulatory adjustment and would result in fewer rate cases, the cost of which would ultimately be paid for by the ratepayer.

There was, however, nothing in that plan when approved that would have allowed for existing customers to provide venture capital to study expansion feasibility, which is what the Expansion Fund and MOU (through allowance of cost recovery for development costs) effectively do. The Company and my colleagues make much of the fact that there may well be benefits to the citizens of Vermont as a whole if the VGS footprint expands into the Addison County area and even more if the footprint expanded to Rutland County and connects to the American system near Lake George, New York. I agree that these statewide benefits may be important and I would encourage the Legislature to consider a method to subsidize this effect. However, asking existing ratepayers in Franklin and Chittenden Counties to underwrite this statewide benefit is unfair and, in my estimation, improper. In this regard, I want to stress that,

under VGS's current financial estimates, the incremental revenue will only cover one-third of the carrying costs of the expansion after ten years. This means that existing ratepayers will have to directly subsidize the expansion, with no direct benefit. In addition, VGS has not provided the Board with a professionally prepared feasibility study indicating that the project is both prudent and viable. At best, VGS has presented the Board with a quasi-educated guess, based on VGS's own internally prepared feasibility model, as to the economics of the project. With only one-third of the carrying costs covered by projected revenues, coupled with the lack of a major load source in the proposed market areas, plus the fact that the project is not yet used and useful, how else should this investment be characterized other than venture capital supplied by existing ratepayers? VGS has essentially assured the Board that "if we build it, they will come," when referring to the economic development prospects of the project. Is this the new standard of prudence that the Board intends to adopt going forward when reviewing similar investments in the future?

I am also concerned that the proposed Expansion Fund, if not used, will not be returned to all customers that contributed to it. There are dockets when a small amount of money was to be refunded and the identity of which ratepayers who were due a refund was hard to ascertain. This inability to track customers forced us to allow those refunds to serve another purpose rather than be refunded. In this case, the "decrease" dollars involved are approximately \$4.4 million annually to be held in escrow with a promise that VGS will track the whereabouts of the ratepayers who would get a refund should we order that the escrow amount created in this docket be repaid to them. I am not convinced that this will occur and, if it does not, it means that existing ratepayers paid rates 5% higher than justified with no benefit.

I am puzzled that the majority is apparently under the impression that VGS is not in a position to contribute the necessary investment capital needed to meet the planning and development costs of the project. As a result, the majority concludes that VGS should be allowed to obtain those funds from ratepayers, apparently ignoring the fact that VGS's parent, Gaz Metro, has more than a sufficient amount of capital available to fund the proposed investment. Indeed, the Board has first-hand knowledge of the financial strength of Gaz Metro since the Board is in possession of Gaz Metro's 2009 annual report. Unfortunately, the Board

was unwilling to consider that information as part of its fact finding in this proceeding. At the technical hearing of June 22, VGS opposed the admission of Gaz Metro's 2009 annual report into the evidentiary record, and the Board unwisely decided not to admit the report.³⁴ Since the financial information contained in Gaz Metro's annual report has direct bearing on the issues considered in this case, and because VGS did not provide any argument showing that the admission of the report would be detrimental or harmful to VGS, I do not concur with the Board's decision to exclude that information.

If the Board had admitted Gaz Metro's 2009 annual report into the record (the report is a public document), the majority would have observed a company that is both prosperous and growing with gross revenue in excess of \$2 billion, net income of \$159 million, operating cash flow (available for capital investments) of \$425 million, and total capitalization of \$2.7 billion.³⁵ Noteworthy is Gaz Metro's annual investment in distribution which totaled \$138.8 million in 2009, up \$13.2 million from 2008, and equivalent to approximately 30.8x the annual investment in the Expansion Fund VGS is proposing to extract from its ratepayers.³⁶

I recognize that VGS has stated that the Expansion Fund is not itself venture capital (and thus the ratepayers who contribute would not receive an equity stake), but it has the same effect. In my estimation, placing the burden of the development costs squarely on the shoulders of existing ratepayers, up front and in advance, while providing VGS with a virtual cost-free source of investment capital, offers no real tangible benefits to those ratepayers. Such an outcome raises serious concern involving both inter-generational equity and the establishment of Board precedent going forward.

I do not believe that the Legislature gave us unbridled authority over ratepayers' funds when it passed the legislation allowing us to approve an alternative regulation plan. Further, even if they did intend to give us broad discretion, I would view this as taking that discretion too far. Since the hearing in this docket, existing ratepayers have faced an 8½% rate increase and appear about to be burdened by another increase at the end of this quarter. Adding a further 5%

34. Tr. 6/22/11 at 77.

35. Gaz Metro, 2009 Annual Report, at 1, 48.

36. *Id.* at 44.

increase on top of these rate changes is unwarranted and unfair absent some likelihood that those ratepayers will receive benefits.

These are difficult financial times for all our citizens, including VGS's customers in Franklin and Chittenden Counties. I must, therefore, dissent.

DATED at Montpelier, Vermont, this 28th day of September, 2011.

s/John D. Burke

John D. Burke, Board Member

OFFICE OF THE CLERK

FILED: September 28, 2011

ATTEST: s/Susan M. Hudson
Clerk of the Board